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SUBJECT: Federal Reserve Visit to Beijing: Impact of Financial
Crisis on Chinese Banks
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¶1. (SBU) Summary: In December 11-12 meetings in Beijing, Chinese and foreign financial sector representatives told San Francisco Federal Reserve Bank Senior Vice President Steven Hoffman that they expect ChinaQs cyclical downturn to increase non-performing loan volumes and reduce bank earnings, but not to the point of a Qseizing upQ of the financial sector. Debate continues among bankers and officials on how best to keep prudent banking and banking supervision from being excessively pro-cyclical, particularly with regard to loans to the private, small- and medium-sized enterprises responsible for most of ChinaQs jobs; such companies typically experience more difficulty securing financing, particularly when perceived credit risks rise. Chinese banks appear set to test whether the U.S. Federal Reserve will allow them to take larger equity stakes in U.S. banks, which will likely impact perceptions among ChinaQs political leadership and the public regarding U.S. openness to foreign investment. End Summary.

¶2. (SBU) During his visit to Beijing, San Francisco FRB Senior Vice President Steven Hoffman met with PeopleQs Bank of China (PBOC) Director General for Financial Stability Zhang Xin, Bank of China General Manager for Overseas Business Management Department Wang Leejun, Industrial and Commercial Bank of China (ICBC) General Manager of Corporate Strategy Department Gu Shu, Dragonomics Managing Editor Tom Miller, Fitch Ratings Senior Director for Financial Institutions Charlene Chu, Price Waterhouse Coopers (PWC) Advisory Services Partner Tim Pagett, and Deloitte-China Consulting Managing Partner Norman Sze. HoffmanQs conversations focused on the severity of the impact of the global economic crisis on the Chinese banks and likely policy responses. In addition, this report also incorporates some points raised in recent meetings by EmbassyQs Economic and Financial Minister-Counselors with officials of the Bank of China and ICBC.

Varying Views on Intensity of Economic Downturn . . .

¶3. (SBU) Miller of Dragonomics noted some similarities of the current crisis to ChinaQs previous Qhard landingsQ in 1989 and 1997. First, all involved exogenous shocks: Tiananmen (a political shock), the Asian Financial Crisis, and todayQs global credit crisis. Second, all involved sharp investment-led cyclical downturns. And third, all occurred when economic structural adjustments were adversely impacting certain sectors: the late 1980Qs price liberalization, the mid-1990Qs state-owned enterprise (SOE) rationalization, and the current attempted shift to more balanced and harmonious growth (less coastal and resource-intensive growth).

¶4. (SBU) One difference, however, is that this time the Chinese Government has been more proactive with fiscal policies. Miller

estimates that 25-50 percent of the RMB four trillion stimulus package already was budgeted prior to its announcement in November, with the rest as new spending. About half of the total will go to general infrastructure and a fourth for post-earthquake re-construction, both of which should boost the steel and cement industries that are depressed due to the downturn in real estate construction. This, Miller believes, will help China maintain a 7-8 percent real GDP growth in 2009. He also predicts steadier and more balanced growth when the economy recovers, and speculated that the Chinese Government's goal is to allow 4 percent RMB appreciation per year against the U.S. dollar. On unemployment, Miller noted the widely held belief that unemployment above five percent would trigger noticeable social unrest, but he conceded that the quality of Chinese unemployment and under-employment data remains poor.

15. (SBU) Fitch's Chu is less optimistic. She believes economic growth will deteriorate further before improving, especially in the southern coastal provinces. SMEs will be severely affected. The current, but not yet published, Fitch forecast for Chinese real GDP growth in 2009 is 6.5 percent, which Chu expects this to be revised down, as the impact of the fiscal stimulus on growth would be limited. In addition, by targeting capital-intensive rather than labor-intensive activities, the stimulus will have only limited impact on unemployment and would exacerbate macroeconomic imbalances.

. . . and the Impact on Chinese Banks

16. (SBU) According to BOC representatives, their bank is involved in two key government initiatives for the banking sector. First, commercial banks will be allowed to provide bridge loans for mergers

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and acquisitions, although this change appears mainly geared towards domestic rather than overseas activity. Second, the China Banking Regulatory Commission (CBRC) is encouraging banks to increase lending to SMEs, which tend to be hit hard during cyclical downturns (in part due to inability to access credit) but which also offer higher lending margins. While the BOC has not set specific targets for SME lending, it will establish special SME credit officers in its branches and also has adopted a SME loan evaluation model from Temasek, one of its foreign strategic partners.

17. (SBU) Despite the cyclical downturn, BOC officials remain confident that deterioration of BOC's major asset classes will be limited. Mortgage lending is mostly to first-time home buyers, for whom NPL ratios traditionally have been low. BOC has strict guidelines on lending for second homes and has limited exposure to commercial real estate. Education loans are extended only to students at accredited universities and are backed by Chinese government guarantees.

18. (SBU) With real estate prices and sales declining, Dragonomics Miller believes the greatest risk facing Chinese banks is their lending to property developers, but he does not foresee a large rise in defaults on home mortgages. Overall performance of banks to date has been good, although problems have grown for coastal branches with large exposure to the export sector. However, Fitch's Chu thinks Chinese banks published accounts overestimate asset quality; she estimates that revenues for some listed banks could fall by almost half next year due to a rise in non-performing loans. Given the deteriorating economic outlook, Chu expects the Chinese banks to remain reluctant to lend despite the government's moral suasion, although they ultimately will relent as both the downturn and government pressure intensify. She also believes the government will cover all losses for the policy banks (including China Development Bank, which recently became a commercial bank), but to mitigate moral hazard the government will ensure that some large state commercial bank losses are not covered, such as losses on their riskier businesses (e.g. subordinated loans).

19. (SBU) Deloitte's Sze stressed that two systemic weaknesses for Chinese banks remain: management information systems and internal

auditing. PWCQs Pagett believes ChinaQs large banks can move relatively quickly towards meeting Basel II standards, though the quality of their compliance is unlikely to be as high as banks in other countries.

International Ambitions

¶10. (SBU) BOC will seek overseas growth through both expansion of its branch network and mergers-and-acquisitions, according to the BOC representatives. It wants more branches in the United States, particularly San Francisco, but remains subject to enforcement actions by the U.S. Comptroller of the Currency for regulatory violations at its New York branch.

¶11. (SBU) For ICBC, the decline in U.S. asset prices is not driving its expansion strategy, as the bank already had decided to expand in the United States long before the financial crisis, in order to follow its corporate clients (e.g., in trade finance and settlement clearing) and service the Chinese immigrant communities (remittances and financial services). ICBC believes, however, that organic growth is too slow so it is considering merger-acquisition opportunities. It currently is engaged in discussions with East-West Bank of California, in which ICBC seeks a larger and possibly controlling stake and thus exemption from the 5 percent ownership cap; in ICBCQs view, a five percent purchase of that bank is Qnot worth it.Q In October 2008 ICBC opened its New York branch, which it wants to expand; while in the United States for the branch opening, the ICBC Chairman met with Treasury Secretary Paulson and noted his bankQs intentions to buy a majority stake in a U.S. bank. ICBC has also informed CBRC of its U.S. plans.

¶12. (SBU) Hoffman explained that the United States was open to foreign participation and that 25 percent of bank assets in the U.S. are held by foreign organizations. Foreign applicants need to meet the same standards as U.S. banks, including financial and managerial soundness and Comprehensive Consolidated Supervision (CCS). The CCS standard for purchasing a controlling stake in a U.S. bank is more rigorous than for just opening a branch. The ICBC officers said

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they understand their bank, as a bank holding company that already has a branch, can only purchase five percent of another bank; banks that are not deemed by U.S. regulators to be bank holding companies, such as China Minsheng, can purchase up to 10 percent.

¶13. (U) VP Hoffman did not have an opportunity to review this report.

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